



*February 26, 2003, except 2003 information
which is August 29, 2003*

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Mr. James T. Odiome
State of Washington
Office of Insurance Commissioner
Post Office Box 40259
Olympia, Washington 98504-0259

Dear Mr. Odiome:

As you have advised, the State of Washington, Office of Insurance Commissioner, (the "Agency") initiated a financial examination for the Agency's review of the proposed conversion of PREMIERA ("Premera" or the "Company") from a not-for-profit entity to a for-profit entity. The Agency subsequently engaged PricewaterhouseCoopers LLP ("PricewaterhouseCoopers" or "PwC") to assist in the examination. PwC has performed analyses of certain historical and prospective financial information and various financial, operating and other data for the Company (the "Services") solely to assist the Agency in its evaluation.

According to your instructions, our services have been limited to the accounting services work requested in the Agency's Request for Proposal related to the proposed transaction (the "RFP"), and as further modified and defined in PwC's September 4, 2002 response to the RFP. A detailed work plan, previously agreed with the Agency, is presented in Appendix 1 of our report, "Accounting and Tax Evaluation of the Proposed Conversion of Premera Blue Cross of Washington". We have also issued a "Report to the Washington State, Office of Insurance Commissioner on Tax Matters in Connection with the Proposed Conversion of Premera" ("Tax Report"). The Tax Report addresses our findings in connection with tax matters associated with the proposed conversion transaction.

The aforementioned analyses of historical and prospective financial information contained in our reports were based upon certain procedures approved by the Agency and performed by PricewaterhouseCoopers. The Agency is responsible for the sufficiency of the procedures as well as for drawing conclusions with respect to PwC's findings.

Information with respect to the Company's operations, account balances and accounting and operating procedures purported to be in effect and described in our reports was obtained through discussions with certain officers and employees of the Company, discussions with the Company's independent accountants, and observations and analysis made by us during the course of our work.

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PricewaterhouseCoopers performed the Services in accordance with Standards for Consulting Services established by the American Institute of Certified Public Accountants (AICPA). PricewaterhouseCoopers' work did not constitute an audit conducted in accordance with generally accepted auditing standards, or an examination or review in accordance with standards established by the AICPA. Accordingly, PricewaterhouseCoopers does not express an opinion or any other form of assurance on the financial statements of the Company or on any financial or other information, or operating and internal controls of the Company.

With respect to prospective financial information relative to the Company referenced throughout our reports, we did not examine, compile or apply agreed-upon procedures to such information in accordance with standards established by the AICPA, and we express no assurance of any kind on such information. There will usually be differences between estimated and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We take no responsibility for the achievability of the expected results anticipated by the management of the Company.

We make no representation regarding the sufficiency of our work either for purposes for which these reports have been requested or for any other purpose. The sufficiency of the work we performed is solely the responsibility of the Agency, as are any decisions with respect to the proposed transaction. Had we been requested to perform additional work, additional matters might have come to our attention that would have been reported to you.

It is understood that these reports are solely for the information of the Agency. PricewaterhouseCoopers' findings may be included in whole or in part in the record upon which any regulatory determination may be made by the Agency, which PricewaterhouseCoopers understands may be a matter of public record. If the Agency chooses to name PricewaterhouseCoopers in any report, the Agency should disclose that PricewaterhouseCoopers is not responsible for the sufficiency of the procedures for the purpose of the Agency's evaluation of the proposed transaction.



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In addition to the foregoing, our reports, or portions thereof, are not to be referred to or quoted, in whole or in part, in any registration statement, prospectus, public filing, loan agreement, or other agreement or document without our prior written approval, which may require that we perform additional work.

We appreciate the opportunity to have assisted the Agency in connection with this engagement. Should you require clarification of any of the matters contained in our reports or any further information, we would be pleased to extend our work as you consider necessary.

Yours very truly,

PricewaterhouseCoopers LLP



Glossary of terms and abbreviations

ABO	Accumulated benefit obligation
ACL	Authorized Control Level
AP	Accounts payable
AFS	Available for sale
ASC	Administrative service contract, a LOB where Premera performs policy administrative functions, such as payment of claims, on a clients behalf. Premera bears no insurance risk on these contracts.
BCBSA	Blue Cross Blue Shield Association
BP	Basis point, which is equivalent to .01%
B&ST	Business and systems transformation project
CAL	Company Action Level
CHS	Calypso Healthcare Solutions
D&O	Directors and Officers liability insurance
E&O	Errors and Omissions liability insurance
ERISA	Employee Retirement Income Security Act of 1974
FY	Fiscal year ended December 31, XXXX
Facet	New core processing system currently under development
FEP	Federal employee program
GAAP	Generally Accepted Accounting Principles
Group	All operating entities included in the consolidated Premera US GAAP financial statements. These include Premera Blue Cross, PremeraFirst, Inc., Washington - Alaska Group Services, Inc., LWA Life Insurance Company [recently renamed LifeWise Health Plan of Arizona], LifeWise Health Plan of Oregon, Quality Solutions, States West Life Insurance Company, Northstar Administrators Inc., LifeWise Administrators, Inc., LifeWise Health Plan of Washington, and Western Benefits Administrators
IBNR	Incurred but not reported claims
LOB	Line of business
LWO	LifeWise Health Plan of Oregon
LWA	LifeWise Health Plan of Arizona
LWAC	LifeWise Assurance Company
LWAI	LifeWise Administrators, Inc.
LWW	LifeWise Health Plan of Washington
MBS	Market business segment
MP	Minimum premium, a LOB where Premera performs policy administrative functions, such as payment of claims, on a clients behalf. Premera does bear insurance risk on these contracts.
NS	NorthStar Administrators, Inc.
OCI	Other comprehensive income - GAAP
OCR	Optical character reader
OIC	State of Washington, Office of Insurance Commissioner
PBC	Premera Blue Cross
PBO	Projected benefit obligation
PFI	PremeraFirst, Inc.
PMPM	Per member per month
RBC	Risk based capital
SOP	AICPA issued Statement of Position
STAT	Statutory Accounting Principles
TAC	Total Available Capital
UEP	Unearned premium
WAGS	Washington - Alaska Group Services, Inc.
WBA	Western Benefits Administrators
WEA	Washington Education Association

Executive Summary

Executive Summary

Approach and Scope of Our Work

- Our engagement consisted of an accounting and tax evaluation of Premera and its subsidiaries including analysis of the consolidated balance sheets and income statements for the quarter ended March 31, 2003, and the years ended December 31, 2002 and 2001. Our procedures included analyzing documents placed in the initial data room in November of 2002, additional documents received through August 29, 2003, review of the Premera's independent accountants' audit workpapers for the three years ended December 31, 2002 and limited meetings (mostly via phone contact) with members of the management team and certain members of Premera's independent audit team. In addition, we participated in several group meetings, status calls and topic specific meetings with the OIC, its advisors, and advisors to the state of Alaska.
- A detailed scope of the procedures are attached as an exhibit to this report and are based on the work agreed to by the OIC.
- Certain requested documents have not been provided for review as they have been deemed privileged and confidential. Some of the documents we requested that were not provided for review include, but are not limited to, summaries of litigation and certain internal audit reports. Had we been able to review the aforementioned documents additional matters of significance may have come to our attention. In addition, the majority of our face-to-face meetings with members of Premera management consisted of group meetings during which the information provided was largely general in nature.

Overview

- Premera is a Washington not-for-profit corporation created in 1994 and is the holding company for the Group, including all of its subsidiaries (collectively referred to as "the Group"). Premera is the sole voting member of PBC and is governed by a self-perpetuating Board of Directors. As a not-for-profit corporation, ownership of the charitable assets are limited to the public of those states in which it operates, or in which it operates via other not-for-profit subsidiaries. Thus, in this case, ownership would be limited to the public of Washington and Alaska. Oregon and Idaho do not have an ownership interest as business is conducted in those states via for-profit subsidiaries.

Executive Summary, continued

As such, the Washington and Alaska Attorneys General have the authority to take action against the Board of Directors on behalf of the citizens of the States of Washington and Alaska in order to protect their ownership interest, if so warranted.

Conversion Summary

- The effect of the proposed conversion will result in the Foundation Shareholder (i.e., the WA and AK charitable trusts) owning 100% of the issued and outstanding capital stock of NEW Premera, and indirectly own 100% of the stock of NEW PBC and subsidiaries. Although the Foundation Shareholder will own 100% of the initial capital stock of NEW Premera it will disclaim "control" of NEW Premera as part of the conversion process.
- Post-conversion, NEW Premera will be owned by the Foundation Shareholder, which will possess 100% financial interest, but proposes to enter into certain voting agreements that will require them to vote any and all interest with Premera's Board of Directors.
- Premera's proposal also provides that the Foundation Shareholder will divest of its NEW Premera stock over a period of time using the net proceeds to promote the health and welfare of the citizens of Washington and Alaska through distribution to charitable organizations.

Executive Summary, continued

- Based upon our understanding of the transaction, it is likely that GAAP accounting will not require a change in the basis of the company's assets and liabilities. Post transaction accounting would result in a reclassification of general reserves to common stock and additional paid in capital. There is no amount allocated to retained earnings. In addition, there is no change in OCI since there was no change to the historical carrying values of assets and liabilities. Further, should the Company pursue an initial public offering, it is unlikely that a change in the basis of the assets or liabilities would be required.

Consolidated GAAP Balance Sheet (Condensed)

(In Thousands)

	Audited Dec 31, 2002	Adjusted Dec 31, 2001 *	\$ Change
Assets:			
Cash and cash equivalents	\$34,630	\$73,498	(\$38,868)
Available-for-sale investments, at fair value:			
Fixed income securities	614,841	490,276	124,565
Marketable equity securities	61,327	125,880	(64,553)
Other investments	14,844	11,621	3,223
Total investments	691,012	627,777	63,235
Accounts receivable	147,111	150,984	(3,873)
Other Assets	61,331	37,435	23,896
Property and equipment, net	68,777	57,969	10,808
Total assets	<u>\$1,002,861</u>	<u>\$947,663</u>	<u>\$55,198</u>
Liabilities:			
Medical claims liability	\$365,400	\$355,715	\$9,685
Experience-rated refunds payable	25,122	16,567	8,555
Unearned revenue	59,609	56,310	3,299
Accounts payable	79,967	83,012	(3,045)
Other liabilities	83,831	84,141	(310)
Total liabilities	613,929	595,745	18,184
Net worth:			
General reserves	371,802	353,884	17,918
Accumulated OCI	17,130	(1,966)	19,096
Total liabilities and net worth	<u>\$1,002,860</u>	<u>\$947,663</u>	<u>\$55,197</u>

Source: December 31, 2002 and 2001 audited financial statements

* The Dec. 31, 2002 financial statements present prior year balances differently than they were presented in the Dec. 31, 2001 financial statements due to reclassifications that do not impact equity. Adjusted Dec. 31, 2001 gives effect to these reclassifications to provide a comparable analysis.

Executive Summary, continued

Investments

- During the third quarter of 2002 Premera began realigning the investment portfolio to decrease the concentration in equity securities to a targeted 8% from 18% at December 31, 2001. This resulted in an increase in fixed income securities held at December 31, 2002. At December 31, 2002 the Company's equity securities represented 9% of the total portfolio.
- As a result of the above, Premera turned their equity portfolio .88 times during 2002 as compared to .34 times the year before. This activity coupled with the significant declines in the equity markets are the most significant factors behind the December 31, 2002 realized loss of \$13.5 million increasing 200% over the prior year's loss of \$4.4 million.
- Premera is purchasing a substantial number of fixed income securities in an environment where interest rates are declining. The impact is apparent when the effective yield of fixed income securities purchased during 2002, and still held at December 31, 2002, of 4.80% is compared to the effective yield of securities held at December 31, 2002 and 2001 of 5.16% and 5.97%, respectively.
- A substantial portion (i.e. greater than 90%) of Premera's fixed income securities had an NAIC designation of 1 or 2 at December 31, 2002. Of the remaining securities (i.e. NAIC 4 – 6 rated), a significant portion were purchased during 2002 indicating that the company is investing in this quality of investment as opposed to holding them while their value deteriorates.
- Management asserted that no derivatives were being used at December 31, 2002 and 2001.
- Premera's realized losses in 2002 comprised of a \$13.5 million net realized loss in equities and \$23.6 million impairment loss on fixed income securities and equities. These losses were offset by a \$2.0 million net realized gain on fixed income securities.

Executive Summary, continued

Impairment

- In 2002, Premera recognized \$23.6 million in impairment charges of which \$11.6 million related to fixed income securities and \$12.0 million related to equities. At December 31, 2002 Premera's criteria for impairment was a 6-month sustained decline in excess of 20% of the carrying value for fixed income securities and 30% for equities.
- Many of the securities impaired in 2002 were underwater in 2001. It is possible that circumstances could have existed prior to the issuance of the 2001 financial statements warranting impairment at an earlier date.
- GAAP requires securities to be impaired when the decline is "other than temporary". The SEC has recently challenged registrants for not impairing equity securities that have been "underwater" for 12 months or greater. If Premera were to adhere to this impairment criteria there would be a negative impact on net income in 2002. This impact has not been quantified, but as equity securities are carried at fair value, there would be no impact to surplus / equity. Although Premera is not currently under the jurisdiction of the SEC, they will be if they pursue an IPO.

Property and Equipment

Sale – Leaseback Transactions

- In 1997 PBC began utilizing sale-leaseback transactions under a master agreement with General Electric Capital Corporation to provide RBC relief by replacing non-admitted assets with cash. Under statutory accounting, all leases are treated as operating, therefore, sale-leaseback transactions enable Premera to enhance their RBC.
- The Company has accounted for the leases entered into under the sale-leaseback transactions as operating leases in its GAAP financial statements. Due to asserted confidentiality with GE, Premera did not provide the master lease agreement. Therefore, PwC was not provided with sufficient detail to independently determine the appropriateness of this accounting; however, based on the limited information reviewed, it is possible we would take exception to such accounting. If all of the leases were treated as capital leases under GAAP, assets and liabilities (debt) could be increased in the \$60 - \$65 million range as of December 31, 2002.

Executive Summary, continued

Risk Based Capital

- The year-end RBC ratios for Premera for 1999 – 2002 have ranged from 378% to 484%. The 2002 year-end RBC ratio was 406%.
- The December 31, 2002 RBC ratios of selected PBC's competitors have varied between 312% and 848%. The ratios for BCBS Kansas and Trigon were 530% and 596%, respectively.
- Management has asserted that the initial conversion transaction will not impact total capital. As a result, RBC should not be impacted. However, an IPO that results in raising new capital will increase RBC.

Executive Summary, continued

Consolidated GAAP Income Statement

(In Thousands)	Audited	Adjusted	\$ Change
	Dec 31, 2002	Dec 31, 2001*	
Revenue:			
Premiums	\$2,556,841	\$2,375,460	181,381
Administrative fees	52,421	44,481	7,940
Other income	8,486	6,867	1,619
Net investment income	30,540	31,485	(945)
Net realized investment gain (loss)	(35,067)	7,515	(42,582)
	2,613,221	2,465,808	147,413
Expenses:			
Health care services	2,149,927	2,006,677	143,250
General and administrative	328,789	296,954	31,835
Commission and brokerage	64,604	59,487	5,117
Premium taxes	38,434	35,743	2,691
Other expense	6,769	4,258	2,511
	2,588,523	2,403,119	185,404
Income before income taxes	24,698	62,689	(37,991)
Income tax expense	6,780	11,532	(4,752)
Net income	\$17,918	\$51,157	(33,239)
Loss ratio	84.1%	84.5%	

Source: Data request response 70, December 31, 2002 & 2001 audited financial statements

* The Dec. 31, 2002 financial statements present prior year balances differently than they were presented in the Dec. 31, 2001 financial statements due to reclassifications that do not impact income. Adjusted Dec 31, 2001 gives effect to these reclassifications to provide a comparable analysis.

- The fluctuation in premium revenue can be attributed to rate increases which are being partially offset by a decline in member months.
 - Premium PMPM: Increases in premiums can be directly attributed to increases in healthcare costs as this is the starting point for management when pricing their business. This is evidenced by the relative stability of the loss ratio.
 - Member months: Management attributed the 2002 decrease to significant competition, both price and product, eroding some of Premera's membership. Management anticipates being able to halt and reverse the decline through the introduction and marketing of the Dimensions products.

Executive Summary, continued

- General and administrative costs increased primarily as a result of higher salaries due to an increase in headcount and the related benefits, higher lease costs due to a year end 2001 sale leaseback, and a change in the classification of certain reimbursements (e.g. Medicare).

Employee Benefit Plans

- Premera has the following benefit programs:
 - Defined Benefit Retirement Program: This plan covers substantially all of Premera's employees. Benefits are based on years of service and an employee's highest earnings during the last ten plan years.
 - Supplemental Defined Benefit Retirement Plan: This is a nonqualified defined benefit plan that is offered to executive management employees only.
 - Deferred Compensation Plan: Premera has a voluntary deferred compensation program for officers. A Deferred Benefit Trust has been established to facilitate the funding of this obligation.
 - Other Defined Benefit SRP Program: Premera has a defined benefit retirement program covering executive management employees. Benefits under this program are based on the average compensation earned during the highest three years of the final five years of employment.
 - Deferred Compensation Retirement Savings Plan: PBC has a 401(K) plan available to substantially all employees. Participants may contribute up to 15% of their compensation and PBC will match the lower of 50% of the participant's contribution or 3%.
 - Other post-retirement benefits (OPEB): Plan provides certain health care benefits for eligible employees who meet retirement age while working for Premera. Other post-retirement benefits are funded at the Company's discretion, which has resulted in no assets being segregated from general corporate assets for the purpose of funding this liability.
 - Physician Deferred Compensation Plan: This is a deferred compensation plan set up prior to 1994. The majority of the plan assets are paid up whole life policies and management has asserted that the Company has no un-mitigated risk with respect to this plan.

Executive Summary, continued

- Actuarial Valuation Assumptions
 - The actuarial valuation for the defined benefit, supplemental defined benefit, and OPEB programs utilized a discount rate assumption of 7.25% at December 31, 2002. PwC would generally not expect a discount rate to exceed 6.75% and notes that the Moody's AA Corporate Bond index at December 31, 2002 was 6.5%. Decreasing the discount rate from 7.25% to 6.50% would increase the December 31, 2002 PBO for the defined benefit, supplemental defined benefit and OPEB programs by approximately \$9.3 million, \$0.5 million and \$3.2 million, respectively. The same adjustment to the ABO would yield increases in the liability of \$29.8 million for the defined benefit and \$500 thousand for the supplemental defined benefit programs. These additional pension liabilities would likely be treated as a reduction to GAAP equity and require additional cash to be contributed into the plan.
 - The assumed long-term rate of return on plan assets was 8.5%. The long-term rate of return has not changed since prior to 2000, which is potentially aggressive considering recent years' decline in equities coupled with decreasing interest rates. Many companies that are not decreasing their long-term rate of return considering the economic environment are being challenged by the SEC. Premera does not currently fall under the jurisdiction of the SEC; however, once the proposed IPO is completed, SEC guidance will be applicable.

Premium and Claims

- Our analysis of the premiums and claims cycles was primarily focused on the "BlueCHIP" mainframe processing system. This system supports the business operations and core processing requirements for approximately half of Premera's insured membership base. Other systems support the Oregon and smaller lines of business (non-PPO). While not the focus of our procedures, we did consider and review the work of Premera's Quality Audit and Internal Audit Departments, and the work papers of the External Auditor as they related to these lines of business and their supporting premiums processing systems. Our examination did not encompass the new "Facets" system.

Executive Summary, continued

- The majority of claims are processed on the BlueCHIP mainframe system. Claims received are either manually keyed into the system or scanned into the system using OCR technology. Aside from front end handling, both OCR and paper claims follow the same adjudication process through the system.
- There is inherent risk in the conversion of systems. [

PROPRIETARY MATERIAL REDACTED

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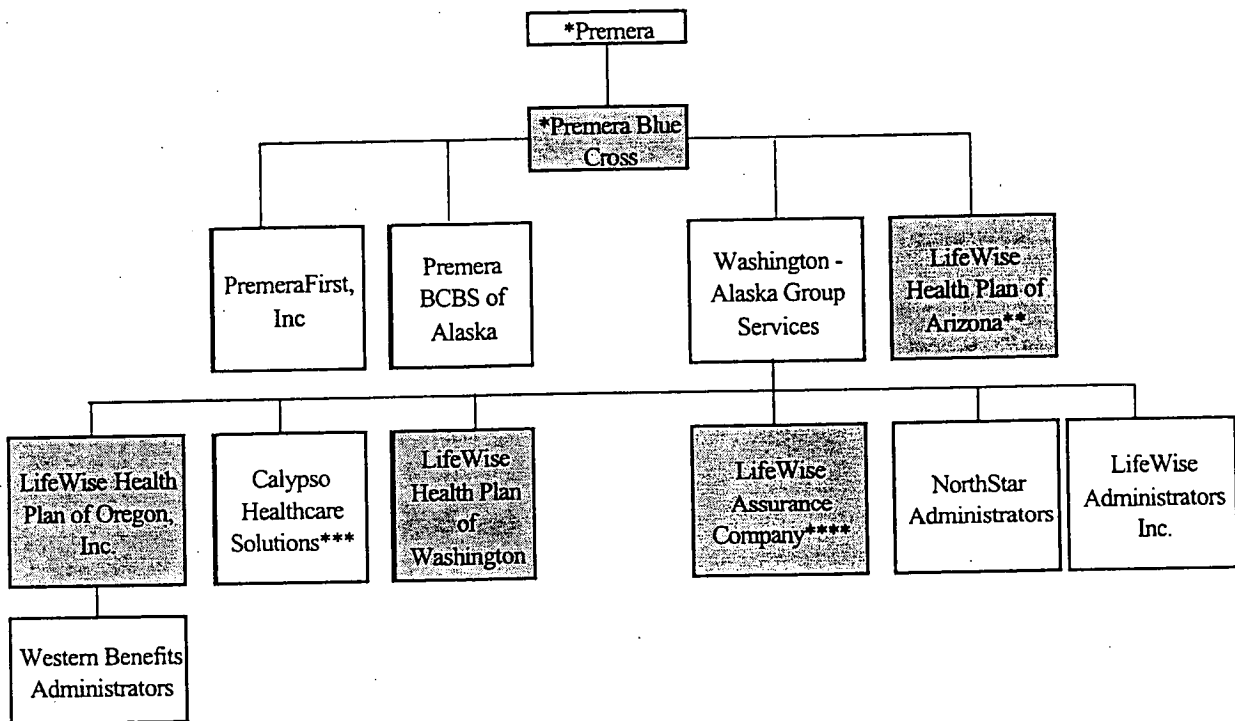
PROPRIETARY MATERIAL REDACTED

Overview



Organizational Chart

- The shaded entities are authorized insurers.
- PBC is the primary operating entity (in terms of business volume) followed in descending order by LWO, LWAC, LWW and LWA.



* Denotes nonprofit entities

** Formerly MSC Life Insurance Company

*** Formerly Quality Solutions

**** Formerly States West Life Insurance Company

Source: Form A, Exhibit WA1

Operating Entities

Premera is a Washington not-for-profit corporation created in 1994 and is the holding company for the Group and sole voting member of PBC. Premera is governed by a self-perpetuating Board of Directors. As a not-for-profit corporation, ownership of the charitable assets are limited to the public of those states in which it operates, or in which it operates via other not-for-profit subsidiaries. Thus, in this case, ownership would be limited to the public of Washington and Alaska. Oregon and Idaho do not have an ownership interest as business is conducted in those states via for-profit subsidiaries. As such, the Washington and Alaska Attorneys General have the authority to take action against the Board of Directors on behalf of the citizens of the States of Washington and Alaska in order to protect their ownership interest, if so warranted.

The remaining entities comprising the Group are summarized as follows:

- PBC is a Washington-domiciled nonprofit corporation licensed as a health care service contractor. PBC is a health care service contractor engaged in the business of providing basic medical, hospital, major medical comprehensive, and other prepaid health care benefits to its subscribers in the states of Washington and Alaska.
- LWA is a Washington State domiciled, for-profit, stock, life and disability insurance company that provides group stop loss coverage to self-insured employer health plans administered by PBC and a wholly owned subsidiary of PBC.
- PFI is a Washington, for-profit corporation utilized primarily to act as an agent to contract with providers on behalf of several of the Premera companies.
- WAGS is a Washington, for-profit corporation licensed as an insurance sales agency in Washington, Alaska, Idaho, and Oregon.
- LWAC is a Washington State domiciled, for-profit, insurance company underwriting group life, accident, disability, and medical contracts. LWAC is licensed in Alaska, Arizona, California, Idaho, Montana, New Mexico, North Dakota, Oregon, Utah, Washington, and Wyoming. LWAC is a subsidiary of WAGS.

Operating Entities, continued

- LWO is an Oregon domiciled, for-profit, insurance company writing individual and group health insurance policies licensed to transact business in Oregon and Idaho. LWO is a subsidiary of WAGS.
- WBA is a third party administrator and is a wholly owned subsidiary of LWO.
- LWW is a not-for-profit healthcare services contractor operating in the state of Washington and is a subsidiary of WAGS.
- NS provides claims administrative services to self-funded plan sponsors and is a subsidiary of WAGS.
- CHS is a not-for-profit Washington State domiciled company that provides investigation and recovery services to health plans and self-funded employer benefit plans. CHS is a subsidiary of WAGS.
- LWAI is an administrative entity that was formed during 2002 to provide consolidated bills to customers that have multiple policies. As of June 25, 2003 management has asserted that this entity is dormant.

Conversion Summary

The following summarizes our current understanding of the significant steps in the proposed conversion transaction:

- Formation of: Foundation Shareholder, WA Charitable Trust and AK Charitable Trust
- Formation of: NEW LifeWise Health Plan of Washington, Premera Blue Cross Blue Shield of Alaska, NEW Premera Blue Cross Corp., and NEW Premera Corp.
- Amend Premera's Articles of Incorporation to provide, among other things, that Foundation Shareholder is the sole voting member of Premera
- LifeWise Health Plan of Washington contributes its assets and liabilities to NEW LifeWise Health Plan of Washington in exchange for its stock
- LifeWise Health Plan of Washington distributes 100% of its assets (stock of NEW LifeWise Health Plan of Washington) to Washington-Alaska Group Services, Inc. and dissolves
- Premera Blue Cross transfers Alaska operations to Premera Blue Cross Blue Shield of Alaska for its stock (creating a subsidiary of Premera Blue Cross)
- Premera Blue Cross contributes its remaining assets and liabilities (including all Washington contracts and stock of all its subsidiaries) to NEW Premera Blue Cross Corp. in exchange for its stock
- Premera Blue Cross distributes 100% of its assets (the NEW Premera Blue Cross Corp. stock) to Premera and dissolves
- Premera contributes 100% of its assets and liabilities to NEW Premera Corp. for its stock
- Premera distributes 100% of its assets (the stock of NEW Premera Corp.) to Foundation Shareholder and dissolves
- The effect of the described process will result in the Foundation Shareholder owning 100% of the issued and outstanding capital stock of NEW Premera, and indirectly own 100% of the stock of NEW PBC and subsidiaries. Although the Foundation Shareholder will own 100% of the initial capital stock of NEW Premera it will disclaim "control" of NEW Premera as part of the conversion process.

Conversion Summary, continued

- Post-conversion, NEW Premera will be owned by the Foundation Shareholder, which will possess 100% financial interest, but proposes to enter into certain voting agreements that will require them to vote any and all interest with the Board of Directors.
- The Foundation Shareholder will divest its NEW Premera stock over a period of time using the net proceeds to promote the health and welfare of the citizens of Washington and Alaska through distribution to charitable organizations.

Source: Premera Form A Filing (dated September 17, 2002), Exhibit A Part 3

Financial Accounting Impact of Conversion

- Based on the guidance in SOP 00-03, a review of similar transactions, and our current understanding of the proposed transaction, it is likely that a change in the basis of the company's assets and liabilities will not be required. Post transaction accounting would result in a reclassification of general reserves to common stock and additional paid in capital. There will be no amount allocated to retained earnings. In addition, there will be no change in OCI since there was no change to the historical carrying values of assets and liabilities. Further, should the Company pursue an initial public offering, it is unlikely that a change in the basis of the assets or liabilities would be required.

Analysis of Certain Proposed "Post Conversion" Agreements

- We have read the Management Agreement by and between New Premera Blue Cross Corp and Premera Blue Cross Blue Shield of Alaska. In addition, we have read the Intercompany Services and Cost Allocation Agreement ("Intercompany Agreement") by and between New Premera and its affiliated subsidiaries and we have read the Intercompany Tax Sharing Agreement ("Tax Agreement"). All of these agreements were attached to the Form A as draft and are not dated. Further, each agreement addresses prospective situations should the conversion be completed.
- The Tax Agreement provides for the allocation of the consolidated tax liability among New Premera and those members that join in the filing of a consolidated federal income tax return. The allocation method generally provides for the allocation of taxes on a separate entity basis with certain consolidating adjustments. The Tax Agreement states that its general intent is

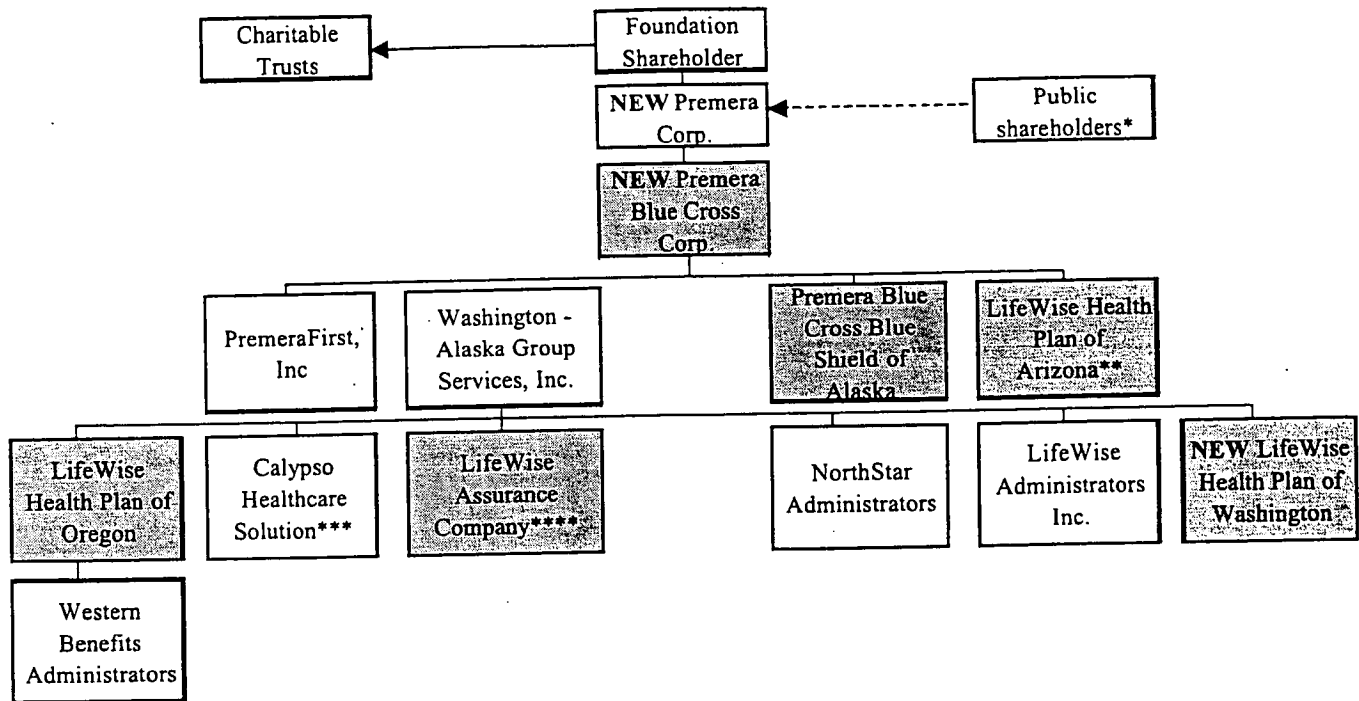
Conversion Summary, continued

that tax savings associated with the use of tax attributes inure to the benefit of the member which generated the attribute. For purposes of the Tax Agreement, tax attributes are defined to include only net operating losses and tax credits. Members are reimbursed for the use of tax attributes when such amounts are used by other members of the group.

Overall, the Tax Agreement is reasonably consistent with other types of tax allocation agreements with one key exception. The exception relates to Section 3.3 of the agreement entitled "Components". This section provides that the parties will not be reimbursed for the use of "components" of taxable income which are defined to include, but do not appear to be limited to, capital losses and excess charitable contributions. This provision could result in situations where members are not reimbursed for certain tax attributes generated on a separate return basis.

- The Management Agreement and Intercompany Agreement address services by and between affiliated entities and the allocation of costs. Based upon our high level analysis of the agreements, nothing came to our attention that would indicate the terms are not fair and reasonable and generally consistent with agreements in place for other consolidated groups. In addition, the terms generally appear to be consistent with current STAT guidance. Our review did not include a detailed review of the appropriateness of each of the line items listed for cost allocation or the potential for other line items that should be included.

Organizational Structure Post Transaction, as proposed



* Should the Company pursue an initial public offering, the shares would likely be issued at this level.

** Formerly, MSC Life Insurance Company

*** Formerly Quality Solutions

**** Formerly States West Life Insurance Company

Source: Form A, Exhibit B-3, modified to reflect entity name changes

Financial Review

Balance Sheet

Consolidated GAAP Balance Sheet

(In Thousands)

	Audited Dec 31, 2002	Adjusted Dec 31, 2001	Reclass	Audited Dec 31, 2001	\$ Change	% Change
Assets:						
Cash and cash equivalents	\$34,630	\$73,498	(\$37,782)	\$111,280	(\$38,868)	-34.9%
Available-for-sale investments, at fair value:						
Fixed income securities	614,841	490,276	-	490,276	124,565	25.4%
Marketable equity securities	61,327	125,880	345	125,535	(64,553)	-51.4%
Other investments	14,844	11,621	(345)	11,966	3,223	26.9%
Total investments	691,012	627,777	-	627,777	63,235	10.1%
Accounts receivable	147,111	150,984	-	150,984	(3,873)	-2.6%
Investment income receivable	6,529	5,960	-	5,960	569	9.5%
Federal income tax recoverable	377	204	-	204	173	84.6%
Deferred compensation plan assets	10,632	11,824	-	11,824	(1,192)	-10.1%
Prepaid expenses and deferred charges	30,849	5,628	-	5,628	25,221	448.1%
Deferred federal income taxes, net	12,944	13,819	-	13,819	(875)	-6.3%
Property and equipment, net	68,777	57,969	-	57,969	10,808	18.6%
Total assets	\$1,002,860	\$947,663	(\$37,782)	\$985,445	\$55,197	5.6%
Liabilities:						
Medical claims liability	\$365,400	\$355,715	(\$2,317)	\$358,032	\$9,685	2.7%
Policy reserves	25,122	16,567	2,169	14,398	8,555	59.4%
Unearned revenue	59,609	56,310	-	56,310	3,299	5.9%
Accounts payable	79,967	83,012	148	82,864	(3,045)	-3.7%
Outstanding checks in excess of bank balances	-	-	(37,782)	37,782	-	0.0%
Deferred compensation plan payable	10,632	11,824	-	11,824	(1,192)	-10.1%
Other liabilities	73,199	72,317	-	72,317	882	1.2%
Total liabilities	613,929	595,745	(37,782)	633,527	18,184	2.9%
Net worth:						
General reserves	371,802	353,884		353,884	17,918	5.1%
Accumulated OCI	17,130	(1,966)		(1,966)	19,096	-971.3%
Total liabilities and net worth	\$1,002,860	\$947,663	(\$37,782)	\$985,445	\$55,197	5.6%

Source: December 31, 2002 and 2001 audited financial statements

Note: The December 31, 2002 financial statements present prior year balances differently than they were presented in the December 31, 2001 financial statements. The differences represent reclassifications that have no impact to equity. The "Audited Dec 31, 2002" and the "Adjusted Dec 31, 2001" columns were taken from the 2002 audited financial statements and the "Audited Dec 31, 2001" column was taken from the 2001 audited financial statements. The significant reclassifications can be summarized as follows:

Consolidated GAAP Balance Sheet, continued

PROPRIETARY MATERIAL REDACTED

The following commentary addresses balances not discussed elsewhere in this report:

- Cash and cash equivalents: The fluctuation in these balances can be attributed to the following:

PROPRIETARY MATERIAL REDACTED

Consolidated GAAP Balance Sheet, continued

• [

PROPRIETARY MATERIAL REDACTED

In addition, the 2002 audited financial statements show favorable development for the Group as a whole to be \$50 million and \$27 million for December 31, 2001 and 2000, respectively. This trend indicates management may have been more conservative in reserving methodologies in recent periods and suggests that the overall loss ratios are improving. The scope of our procedures did not include a detailed, independent reserve calculation and therefore, we are unable to comment on the specific blocks of business that have held redundant reserves.

PROPRIETARY MATERIAL REDACTED

- General reserves: This fluctuation is entirely attributable to current year net income.

Investment Overview

Investment controls noted

Premera has several levels of review in place surrounding their investment function which include:

- Board of Directors: Provides final review and oversight of the investing activities.
- Investment, audit and compliance committee ("Investment committee"): Establishes and monitors investment policy and reviews the performance of investment managers.
- Investment staff: Provides portfolio analyses to determine adherence with investment policy and applicable laws and regulations. In addition, they recommend the engagement or termination of investment managers and procedures for adequate internal controls.
- Investment consultants: External advisors whose primary responsibilities include making recommendations to staff and the investment committee regarding investments, asset allocation strategies, selection of custodian and investment managers. In addition, consultants provide economic data, market trends, regulatory updates, research and education on investment subjects.
- Investment managers: External advisors who determine security selection, subject to the investment policy, and execute and settle transactions with broker / dealers as needed. In addition, managers provide complete custody and depository services for the designated accounts and maintain frequent and open communication with the Investment committee, submitting written suggestions to changes in policy when warranted.

Investment policy

- Premera is authorized to utilize short-term investments, fixed income investments, Yankee securities (securities denominated in US dollars issued by foreign issuers), asset-backed securities, mortgage related securities, convertible securities and common equities.
 - Fixed income securities are restricted to S&P rating of BBB- or better or a rating from Moody's equal to or greater than Baa3
- Premera authorizes the use of derivatives to control portfolio risk and prohibits their use for speculative purposes.

Investment Overview, continued

PROPRIETARY MATERIAL REDACTED

General

- For GAAP purposes, Premera classifies all securities as AFS, which requires them to be carried at fair value. The change in fair value is taken to OCI.

PROPRIETARY MATERIAL REDACTED

- No members of the Group have significant investments in the debt of other Group members.

PROPRIETARY MATERIAL REDACTED

- Management has asserted that no derivatives are being used at December 31, 2002 and 2001.

Investment Analysis

Fixed Income

Quality distribution of fixed income securities:

<i>(In Thousands)</i>	Fair Value Dec 31, 2002		Fair Value Dec 31, 2001	
NAIC - 1 Rated	\$468,810	76.6%	\$378,355	77.2%
NAIC - 2 Rated	99,276	16.2%	77,137	15.7%
NAIC - 3 Rated	31,661	5.2%	29,991	6.1%
NAIC - 4 Rated	10,576	1.7%	4,328	0.9%
NAIC - 5 Rated	1,680	0.3%	-	0.0%
NAIC - 6 Rated	357	0.1%	-	0.0%
	<u>\$612,360</u>	<u>100.0%</u>	<u>\$489,811</u>	<u>100.0%</u>

Source: Schedule Ds

- The fair value presented within Schedule D differs from the fair value within the GAAP financial statements by \$2.5 and \$.5 million at December 31, 2002 and 2001, respectively. Management asserts that this difference is attributable to different pricing sources (i.e. SVO for Schedule D and Bank of New York for the financial statements). This difference represents less than 0.5% of the fixed income portfolio.
- Approximately 93% of Premera's fixed income securities have an NAIC designation of 1 or 2 at December 31, 2002.
 - Of the NAIC 1 & 2 rated securities, 4 had an unrealized loss greater than 10% of carrying value and \$50,000. The total unrealized loss of these securities is \$2.6 million. For impairment consideration regarding these and other securities refer to the Realized Gains and Losses section of this report.
- For securities with an NAIC rating of 3 through 6 at December 31, 2002:
 - Management has asserted that they hired a high yield fund manager during 2002 to target this sector of investments.
 - Issuing companies appear to be making timely interest payments.
 - No security was noted to have an unrealized loss.
 - NAIC 3 rated: 75% were purchased during the fourth quarter of 2002. Of the remaining securities, a substantial number were purchased earlier in 2002.

Investment Analysis, continued

- NAIC 4 rated: Approximately 40% were purchased during 2002. Of the securities which were purchased prior to 2002, 1/3 was Continental Airlines on which the company has recorded an impairment charge.
- NAIC 5 rated: Approximately 80% were purchased during 2002.
- Considering the above facts, management appears to be investing in this quality of investment as opposed to holding these securities while the value declines. In addition, management has recorded impairment charges on some of these investments, which supports the fact that there is no unrealized loss on NAIC 3 - 6 rated securities.

Yield analysis

Securities purchased during 2002:

(In Thousands)

Company	Amortized cost of securities purchased	Wgt. Avg. Effective Yield
PBC	\$323,535	4.64%
LWO	69,901	5.28%
SWL	35,456	5.05%
LWW	18,391	5.20%
MSC	3,309	5.32%
	<u>\$450,592</u>	
Wgt. Avg. Yield		<u>4.80%</u>

Source: Schedule D

- Premera has recently purchased a substantial number of fixed income securities in an environment where interest rates are declining. The impact is apparent when the effective yield of fixed income securities purchased during 2002, and still held at December 31, 2002, of 4.80% is compared to the effective yield of securities held at December 31, 2002 and 2001 of 5.15% and 5.97%, respectively.

Investment Analysis, continued

Holdings as of December 31, 2002 and 2001:

(In Thousands)	December 31, 2002		December 31, 2001		Change in Yield
	Amortized Cost	Wgtd Avg. Yield	Amortized Cost	Wgtd Avg. Yield	
Company:					
PBC	\$428,518	5.06%	\$372,605	6.00%	-0.94%
LWO	93,717	5.50%	68,287	5.89%	-0.39%
SWL	42,151	5.26%	38,764	5.87%	-0.61%
LWW	18,543	5.18%	155	3.10%	2.08%
MSC	7,757	5.65%	7,750	5.64%	0.01%
Weighted total	\$590,686	5.16% *	\$487,560	5.97% *	-0.81%

* Calculated as Amortized cost X Weighted Av. Yield per security divided by total weighted average yield.

PROPRIETARY MATERIAL REDACTED

- The decline in the weighted average investment yield on fixed income securities of 81BP (5.97 to 5.16) will have a negative impact on future investment income.
 - A 50 BP decline results in an approximate \$3 million decline in investment income, based on the December 31, 2002 amortized value.
- Prior to 2000 LWW had no operations and at December 31, 2001 they only held one fixed income security. During 2002 LWW's operations increased as it created a new line of business for individuals and began selling individual products. In conjunction with LWW's increase in business, the investment balance also increased, which results in a more comparable weighted average yield in 2002 as compared to 2001.

Investment income receivable analysis:

(In Thousands)	Dec 31, 2002	Dec 31, 2001
Investment income receivable	\$ 6,529	\$5,960
Avg. Inv. Balance	645,990	595,462
	1.0%	1.0%

PRICewaterhouseCOOPERS

Investment Analysis, continued

- Investment income receivable is comprised of accrued interest and dividends and has remained stable at 1% of Premera's average investment balance.
 - Investment income receivable of \$6,529 and \$5,960 agrees to the accrued dividends and interest income per Schedule D when adjusted for interest receivable of the non-insurance entities.

Equities

General

- Equity securities exclude investments in the equity of subsidiaries, which are consolidated for GAAP purposes.
- During the third quarter of 2002 Premera began realigning the investment portfolio to decrease the concentration in equity securities to a targeted 8% from 18% at December 31, 2001. This resulted in an increase in fixed income securities held at December 31, 2002. At December 31, 2002 the Company's equity securities represented 9% of the total portfolio.
- With the exception of Silchester, all of Premera's equity investments, as of December 31, 2002, had an NAIC designation of L indicating the securities are listed on the NYSE, NASDAQ or American Stock Exchange.
- For price testing of equity and fixed income securities refer to Appendix 2 of this report.

• [Proprietary Material Redacted]

Quality of investments

- At December 31, 2002 the equity portfolio had a net unrealized loss of \$1.7 million comprised of an unrealized gain of \$4.4 million offset by unrealized losses of \$6.1 million.
 - \$3.9 million of the \$6.1 million of unrealized loss is generated by 7 securities, which had not been impaired, and had an unrealized loss greater than 10% and \$150,000. Two of these securities are in the top 10 largest

Investment Analysis, continued

PROPRIETARY MATERIAL REDACTED

- Equity securities not traded on national security exchanges could be considered a greater risk, however, Silchester's price (as provided by management) has remained stable at 23.04, 24.38 and 23.53 at December 31, 2001, 2002 and January 31, 2003, respectively.

*Spread of equity risk***Significant equity holdings at December 31, 2002:**

<i>(In Thousands, except Price)</i>	Shares held	Price	Fair value
1 Silchester Int'l Value Eq Tr Fund	311	\$24.39	\$7,578
2 Legg Mason Battmar s/c Eq	919	8.20	7,532
3 Europacific Growth Fund	320	22.97	7,354
4 Exxon Mobil Corp	38	34.94	1,343
5 Citigroup Inc.	29	35.19	1,011
6 Vanguard Total Stk Mk Ind.	46	20.07	915
7 Verizon Communications Inc.	23	38.75	881
8 American International Group	14	57.85	820
9 Bank Of America Corp	10	69.57	674
10 Plum Creek Timber Co	28	\$23.60	668
	<u>1,737</u>		<u>\$28,778</u>
Total equities			<u>\$61,327</u>
% of total			<u>46.9%</u>

Source: Schedule Ds

- Presented above are Premera's ten largest equity holdings as of December 31, 2002 which comprise 45% of the equity portfolio.
- Silchester is the largest equity holding comprising 12% of the total equity portfolio, however, the fair value of Silchester only represents 2% of Premera's total equity.

Employee Benefits

The scope of PwC's work did not include a detailed actuarial review of Premera's benefit programs.

Defined Benefit Retirement Program / Pension equity plan:

<i>(In Thousands)</i>	Dec 31, 2002	Dec 31, 2001
<i>Balance sheet</i>		
Fair value of plan assets	\$82,273	\$58,695
Benefit obligation (PBO)	(88,604)	(76,719)
Underfunded status of plan	(6,331)	(18,024)
Unrecognized net actuarial loss	30,634	14,776
Unrecognized prior service cost	(2,586)	(3,176)
Prepaid (accrued) pension cost	<u>\$21,717</u>	<u>\$(6,423)</u>
<i>Income statement</i>		
Service and interest expense	\$10,927	\$9,404
Return on assets	(5,427)	(4,937)
Net (gain) / loss recognition	339	-
Prior service cost amortization	(349)	(349)
Transition obligation recognition	(241)	(301)
Net periodic pension cost	<u>\$5,249</u>	<u>\$3,817</u>
<i>ABO</i>	<u><u>\$(81,765)</u></u>	<u><u>\$(66,160)</u></u>

Source: Data response 469

Note: The \$21.7 million pre-paid asset is included within "Prepaid expenses and deferred charges" on the balance sheet. The prior year accrued pension cost is included within other liabilities.

- Plan covers substantially all of Premera's employees. Benefits are based on years of service and an employee's highest earnings during the last ten plan years. Premera's policy is to fund, at a minimum, the amount required by ERISA.
- The PBO is being discounted using a weighted average rate of 7.25% and 7.75% at December 31, 2002 and 2001, respectively. The assumed rate of increase in future compensation levels varies between 3.5% and 7%, and the assumed long-term rate of return on plan assets is 8.5%.

PROPRIETARY MATERIAL REDACTED

Employee Benefits, continued

- At December 31, 2002 PwC would generally not expect a discount rate to exceed 6.75%, and notes that the Moody's AA Corporate Bond index at December 31, 2002 was 6.5%. This index is often used as an indicator of the discount rate utilized in estimating the PBO. The impact of varying the discount rate can be roughly estimated by assuming a 50BP change will impact the PBO by 6% to 8%. Decreasing the discount rate from 7.25% to 6.50% would increase the December 31, 2002 PBO by approximately \$9.3 million. This would increase the net actuarial loss from \$30.6 million to approximately \$39.9 million. The 2001 discount rate could also be considered aggressive, however, since the 2002 balances are the most relevant, 2001 balances were not subject to further analysis.
- The same general rule applies for the ABO, which represents the liability for services provided to date and excludes the liability for future services. If the discount rate were decreased to 6.5% from 7.25% this would result in an ABO of approximately \$90.4 million. GAAP requires the company to show a liability at least equal to the amount the ABO exceeds the fair value of plan assets. Currently, plan assets exceed the ABO, however, if the discount rate were reduced to 6.5%, this would result in a net liability of approximately \$8.1 million needing to be recognized and a recognition of an additional minimum liability of \$29.8 million. If an additional pension liability is required to be accrued, GAAP allows for the establishment of an intangible asset to the extent of any unrecognized positive prior service cost. Any amount in excess of unrecognized prior service cost is required to be treated as a reduction to OCI. As the unrecognized prior service costs are zero, the offset to the \$29.8 million would be a reduction to OCI.
- Sufficient information to assess the reasonableness of the long-term rate of return on plan assets has not been provided. The long-term rate of return has not changed since prior to 2000 which is potentially aggressive considering recent years' decline in equities coupled with decreasing interest rates.
 - Companies not decreasing their long-term rate of return considering the economic environment are being challenged by the SEC. Premera does not currently fall under the jurisdiction of the SEC, however, they will if they proceed with their plan to complete a public offering.

Employee Benefits, continued

STAT

- Pension plans are accounted for similarly under STAT and GAAP. One notable exception is as follows:

[PROPRIETARY MATERIAL REDACTED]

Supplemental Defined Benefit Retirement Plan

<i>(In Thousands)</i>	Dec 31, 2002	Dec 31, 2001
<i>Balance sheet</i>		
Benefit obligation at end of year	(4,507)	(3,048)
Fair value of plan assets	-	-
Unrecognized net actuarial loss	479	223
Unrecognized prior service cost	1,635	1,254
Prepaid/(Accrued) pension cost (prior to additional liability)	(2,393)	(1,571)
Additional pension liability	(1,865)	-
Unfunded ABO	(4,258)	(1,571)
Intangible asset	\$1,635	-

Source: December 31, 2002 audited financial statements

Note: The \$4.3 million and \$1.6 million accrued benefit cost at December 31, 2002 and 2001, respectively, are included within Other liabilities. The \$1.6 million intangible asset is included within prepaid expenses.

- Plan is a nonqualified defined benefit plan that is offered to executive management employees only.
- The PBO is being discounted using a weighted average rate of 7.25% and 7.75% at December 31, 2002 and 2001, respectively. The assumed rate of increase in future compensation levels is 5%. As noted on the previous page, PwC notes that a 6.50% discount rate is more common among public companies. If the discount rate were changed to 6.50% the PBO would increase by approximately \$500 thousand.

Employee Benefits, continued

- The unfunded accumulated benefit obligation is \$4.3 million and is required to be presented as a liability since no assets have been contributed to the plan. PBC has recorded a \$1.6 million intangible asset and a \$230 thousand reduction to OCI. If the discount rate were changed to 6.50% then the ABO would increase by approximately \$500 thousand. This would be treated as a reduction to OCI. For a discussion regarding the proper accounting when the ABO exceeds the fair value of plan assets refer to the previous page.

Other Supplemental Retirement Programs:*(In Thousands)*

	Dec 31, 2002	Dec 31, 2001
<i>Defined contribution & Deferred Comp.</i>		
Fair Value of Trust Assets	\$13,632	\$10,674
Deferred Compensation	(13,806)	(10,878)
Net liability	<u>\$(175)</u>	<u>\$(204)</u>

Defined benefit

Defined benefit SRP liability	\$(2,393)	\$(885)
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Source: General ledger

- The fair value of trust assets per the Audited Financial Statements is \$14.0 million and \$11.4 million at December 31, 2002 and 2001, respectively.
- Included within the liabilities presented above are amounts related to PBC's nonqualified defined contribution program covering executive management employees and the deferred compensation plan for officers.
- Deferred Benefit Trust / Deferred Compensation / Unrealized Gain/Loss-Trust: Premera has a nonqualified defined contribution retirement program covering executive management employees. Benefits under the defined benefit retirement program are based on years of service and the participants' highest earnings during the term of service. Premera also has a deferred compensation plan for officers under which participation is voluntary. The liability for both of these programs is presented above under the heading Deferred Compensation. Premera funds the deferred benefits of both of these programs through the establishment of a Deferred Benefit Trust. Trust assets comprise approximately 92% of the December 31, 2002 "other investments" presented on the balance sheet. The related liabilities (Deferred Compensation) are included within "other liabilities". Plan assets are held in trust and carried at fair value. Changes in fair value are offset with an equal change in the corresponding liability. The Management, Officers and Directors participating in the plan do not have a secured interest.

Employee Benefits, continued

- Defined benefit SRP liability: Premera has a defined benefit retirement program covering executive management employees. Benefits under this program are based on the average compensation earned during the highest three years of the final five years of employment. The amount presented above ("Defined benefit SRP liability") represents the PBO. Premera does not separately account for assets backing the Defined benefit SRP plan, however, have identified \$1.3 million of their equity investments to be used to partially settle this liability.

Deferred Compensation Retirement Savings Plan:

PBC has a 401(K) plan available to substantially all employees. Participants may contribute up to 15% of their compensation and PBC will match the lower of 50% of the participant's contribution or 3%. The unfunded liability associated with this plan was minimal at December 31, 2002 and 2001, respectively.

Other post- retirement benefits (OPEB)

(In Thousands)

	Dec 31, 2002	Dec 31, 2001
<i>PBO rollforward</i>		
Benefit obligation at beginning of year	(\$15,939)	(\$13,341)
Service and interest cost	(2,345)	(1,382)
Actuarial loss	(3,331)	(1,892)
Amendments	(5,874)	-
Benefits paid	472	676
Benefit obligation at end of year	(27,017)	(15,939)
Fair value of plan assets	-	-
Underfunded status of plan	(27,017)	(15,939)
Unrecognized prior service cost	5,455	-
Unrecognized net actuarial loss	5,414	2,163
Accrued pension cost	(16,148)	(13,776)
Pension equity plan (unfunded) position	-	(6,423)
Total amount included in other liabilities	(\$16,148)	(\$20,199)

Source: Data request response 469A

Note: The \$16,148 and the \$20,199 presented above are included within Other Liabilities. There was no amount related to the pension equity plan added during 2002, as the plan is over-funded with the related asset being included in "Prepaid expenses & deferred charges".

Employee Benefits, continued

- The plan provides certain health care benefits for eligible employees who meet retirement age while working for Premera.
- Other post-retirement benefits are funded at the company's discretion, which has resulted in no assets being segregated from general corporate assets for the purpose of funding this liability.
- At December 2001, the PBO was discounted using a weighted average rate of 7.75%. At the end of 2002 the company reduced their discount rate to 7.25%. PwC would typically not expect a discount rate to exceed 6.75% at December 31, 2002 and notes that the Moody's AA Corporate Bond index at December 31, 2002 was 6.5%. This index is often used as an indicator of the discount rate utilized in estimating the PBO. The impact of varying the discount rate can be roughly estimated by assuming a 50BP change will impact the PBO of an OPEB plan by 7% to 9%. Decreasing the discount rate from 7.25% to 6.50% would increase the December 31, 2002 PBO by approximately \$3.2 million. Other post-retirement benefits do not have the same ABO requirements outlined on previous pages, therefore, it is not necessary to consider if any unexpected impact on surplus will exist.

• [PROPRIETARY MATERIAL REDACTED

] These trends, and the rate of reduction, are comparable to what PwC has seen within the industry. Accenture published a study on healthcare industry trends that estimates health care costs are expected to increase 7.5% per year through 2006.

[• PROPRIETARY MATERIAL REDACTED]

Employee Benefits, continued

Physician Deferred Compensation Plan

	Dec 31, 2002	Dec 31, 2001
Physician plan assets	\$10,632	\$11,824
Physician's PBO	(10,632)	(11,824)
Net asset	<u>\$0</u>	<u>\$0</u>

Source: General ledger

- Physician plan balances are presented separately on the balance sheet under "Deferred compensation plan assets (liabilities)".
- Prior to 1994, LWA administered a deferred compensation plan which allowed for a reduction of earnings in exchange for a promise to pay specified amounts upon a physician's retirement.
 - The plan administrator is Target Planning Corporation
 - The majority of plan assets are paid up whole life policies issued by Integrity Life Insurance Company of Cincinnati, which has an AM BEST rating of A+.
- Management has asserted that they have no un-mitigated risk with respect to this plan and that the liability will always equal the fair value of plan assets.

Accounts Receivable Analysis

PROPRIETARY MATERIAL REDACTED

Accounts Receivable Analysis, continued

PROPRIETARY MATERIAL REDACTED

Accounts Receivable Analysis, continued

PROPRIETARY MATERIAL REDACTED

Accounts Receivable Analysis, continued

[
----- PROPRIETARY MATERIAL REDACTED -----	
]	

Property Plant & Equipment

Analysis of PP&E & related depreciation / amortization:

(In Thousands)	Dec 31,	Dec 31,	\$ Change	% Change
	2002	2001		
Land, Building & improvements	\$62,410	\$59,004	\$3,406	5.8%
PROPRIETARY MATERIAL REDACTED				
Software capitalized	14,588	12,316	2,273	18.5%
PROPRIETARY MATERIAL REDACTED				
Net, PP&E	<u>\$68,777</u>	<u>\$57,969</u>	<u>\$10,808</u>	<u>18.6%</u>

Source: General ledger

PROPRIETARY MATERIAL REDACTED

PROPRIETARY MATERIAL REDACTED

Property Plant & Equipment, continued

PROPRIETARY MATERIAL REDACTED

Sale-Leaseback Transactions

PROPRIETARY MATERIAL REDACTED

PROPRIETARY MATERIAL REDACTED

GAAP

One of the criteria for classifying a transaction as an operating lease is that the present value of the minimum lease payments cannot exceed 90% of the fair market value.

PROPRIETARY MATERIAL REDACTED

Sale-Leaseback Transactions, continued

PROPRIETARY MATERIAL REDACTED

The scope of this project did not specifically include an independent verification of the sale-leaseback agreements. However, based upon the information available it is possible that upon a detailed review of the leases, we would take exception to historical accounting as operating leases for GAAP purposes. If the leases were treated as capital leases under GAAP, assets and liabilities (debt) would be increased in the \$60 - \$65 million range as of December 31, 2002.

STAT

As SSAP 22 indicates that all leases shall be considered operating leases, the issues noted above would not result in the leases being considered capital leases for STAT purposes.

Unearned Premium

PROPRIETARY MATERIAL REDACTED			
Administrative fees	(52,421)	(175,805)	(137,541)
Other income	(8,486)	(31,826)	(24,618)
Premiums per I.S.	\$2,556,842	\$2,337,342	\$1,929,699

Unearned Premium

PROPRIETARY MATERIAL REDACTED			
Total	\$59,609	\$56,310	\$45,927

PROPRIETARY MATERIAL REDACTED			
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Unearned Premium, continued

PROPRIETARY MATERIAL REDACTED

Financial Review

Accounts Payable

PROPRIETARY MATERIAL REDACTED

\$79,967

\$82,864

\$ (2,897)

-3.5%

PROPRIETARY MATERIAL REDACTED

Other liabilities

PROPRIETARY MATERIAL REDACTED

Other Comprehensive Income

Historical Unrealized Gains/Losses:

<i>(In Thousands)</i>	Dec 31, 2002	Dec 31, 2001	Dec 31, 2000	Dec 31, 1999
<i>Fixed income securities</i>				
Unrealized gains	\$25,887	\$8,843	\$14,020	\$2,878
Unrealized losses	(2,846)	(9,399)	(5,015)	(14,455)
Net unrealized gains/(losses)	23,041	(556)	9,005	(11,577)
<i>Marketable equity securities</i>				
Unrealized gains	4,460	16,630	15,237	14,670
Unrealized losses	(6,114)	(18,464)	(14,400)	(4,888)
Net unrealized gains/(losses)	(1,654)	(1,834)	837	9,782
Net unrealized gain/losses	21,387	(2,390)	9,842	(1,795)
Tax effect of unrealized gains/(losses)	(4,257)	423	(1,794)	3,236
	<u>\$17,130</u>	<u>(\$1,966)</u>	<u>\$8,049</u>	<u>\$1,442</u>

Source: Discussions with management & audited financial statements

Fixed income securities

- **Unrealized gains:** Although the company is purchasing fixed income securities in an environment where interest rates are declining they still hold a substantial portfolio with coupon rates in excess of what is currently attainable within acceptable risk limits. The weighted average coupon (using par as the weight and excluding securities which were not given a yield within schedule D) of securities with an unrealized gain at December 31, 2002 was 6.34%. At the same time, the weighted average yield of securities purchased during 2002 was 4.80%. Since there is a considerable difference between the yields currently attainable of 4.80% and the 6.34% the company holds, it is reasonable to anticipate a significant unrealized gain on these securities. This unrealized gain will continue to fluctuate with movements in interest rates.
- **Unrealized losses:** During 2002 Premera recorded \$11.6 million of impairment losses on fixed income securities and realized \$10 million of losses (excluding impairment). Both of these transactions reduce the unrealized losses remaining in OCI. Therefore, additional unrealized losses partially offset this reduction for a year end 2002 unrealized position of \$2.8 million.

Other Comprehensive Income, continued

Marketable equity securities

- **Unrealized gains:** During 2002 Premera shifted the mix of the portfolio to be more heavily weighted in fixed income securities, which has resulted in Premera selling a considerable number of equity securities. The realized gains on equity securities is up approximately 4%, which explains a portion of the fluctuation in unrealized gains seen here. The remaining fluctuation can be explained by the overall decline in the equity markets (i.e., 23% decline in S&P in 2002).
- **Unrealized losses:** As a result of Premera shifting their portfolio mix, realized losses on equity securities is up \$13 million over 2002 (excluding impairment). When this is considered, the fluctuation between 2001 and 2002 appears reasonable.

Financial Review

RBC Analysis

Premiera RBC ratios:

(In Thousands)

	2002	2001	2000	1999
<i>PBC</i>				
Total Available Capital	\$311,742	\$329,104	\$272,549	\$250,535
Authorized Control Level Capital	76,730	78,296	72,009	52,082
Calculated RBC ratio	406%	420%	378%	481%

Competitor RBC ratios:

Regence Blue Shield (24% WA Mkt Shr.)	631%	746%	579%	802%
Grp. Hth. Cop. of Pug. Snd. (18% WA Mkt Shr.)	404%	432%	392%	369%
Com. Hth. Plan of WA (6% WA Mkt. Shr.)	848%	783%	628%	712%
PacifiCare of WA Inc.(4% WA Mkt. Shr.)	311%	503%	456%	731%

Selected Other Ratios:

BCBS Kansas	530%	662%	703%	869%
Trigon Insurance Company	595%	486%	604%	746%

Source: 2002 Annual statements

The NAIC's RBC framework compare an insurer's capital base, TAC, to varying levels of capital which trigger certain actions. The ratios in the table above compare TAC to ACL. ACL is the level at which the regulator is authorized to take whatever actions are required to protect the best interests of policyholders. The minimum level of regulatory oversight occurs at the CAL, which is 200% of ACL, the minimum capital required to support the insurer's business operations. At the CAL, management must submit an RBC Plan to the commissioner of their state of domicile which describes the action planned to restore the capital to a level at which it is not impaired.

As indicated in the table above, PBC has exceeded the CAL in each of the past four years. The Blue Cross Blue Shield Association early warning level is 375%, which PBC exceeded in each of the past four years.

Income Statement

Consolidated GAAP Income Statement

(In Thousands)	Audited Dec 31, 2002	Adjusted Dec 31, 2001	Reclass	Audited Dec 31, 2001	\$ Change	% Change
Revenue:						
Premiums	\$2,556,841	\$2,375,460	\$25,769	\$2,349,691	181,381	7.6%
Administrative fees	52,421	44,481	(131,324)	175,805	7,940	17.9%
Other income	8,486	6,868	(24,958)	31,826	1,618	23.6%
Net investment income	30,540	31,490	5	31,485	(950)	-3.0%
Net realized investment gain (loss)	(35,067)	7,515	-	7,515	(42,582)	-566.6%
	2,613,221	2,465,814	(130,508)	2,596,322	147,407	6.0%
Expenses:						
Health care services	2,149,927	2,006,677	(140,231)	2,146,908	143,250	7.1%
General and administrative	328,789	296,954	9,717	287,237	31,835	10.7%
Commission and brokerage	64,604	59,487	-	59,487	5,117	8.6%
Premium taxes	38,434	35,743	-	35,743	2,691	7.5%
Other expense	6,769	4,264	6	4,258	2,505	58.7%
	2,588,523	2,403,125	(130,508)	2,533,633	185,398	7.7%
Income before income taxes	24,698	62,689	-	62,689	(37,991)	-60.6%
Income tax expense	6,780	11,532	-	11,532	(4,752)	-41.2%
Net income	\$17,918	\$51,157	\$0	\$51,157	(33,239)	-65.0%
Loss ratio	84.1%	84.5%		91.4%		

Source: Data request response 70, December 31, 2002 & 2001 audited financial statements

The December 31, 2002 financial statements present prior year balances differently than they were presented in the December 31, 2001 financial statements. The differences represent reclassifications that have no impact to income. The "Audited Dec 31, 2002" and the "Adjusted Dec 31, 2001" columns were taken from the 2002 audited financial statements and the "Audited Dec 31, 2001" column was taken from the 2001 audited financial statements.

The "Reclass" column shows the impact the presentation differences outlined above would have had on the December 31, 2001 financial statements. This is necessary to present 2001 on a comparable basis as 2002. The "\$ Change" and the "% Change" columns are being calculated using the "adjusted December 31, 2001", and "audited December 31, 2002" columns.

The impact of the reclass adjustments can be summarized as follows:

- Premiums: Certain revenue items previously included in other income are now being classified as premium.
- Administrative fees: In prior years, Premera accounted for reimbursable paid losses as revenue. During 2002, only the related fee was presented as revenue. This adjustment is being partially offset by a reclassification of certain G&A items.

Consolidated GAAP Income Statement, continued

PROPRIETARY MATERIAL REDACTED

- Premium taxes: Premium taxes are typically 2% of written. This rate varies by state and not all LOBs are subject to premium tax. Premium tax expense for the years ended December 31, 2002 and 2001 was 1.5% of written premiums.

Consolidated GAAP Income Statement, continued

PROPRIETARY MATERIAL REDACTED

Premium Revenue Analysis

PROPRIETARY MATERIAL REDACTED

Premium Revenue Analysis, continued

PROPRIETARY MATERIAL REDACTED

Investment Income Analysis

PROPRIETARY MATERIAL REDACTED

- Interest income – ST Investments: Investment income on ST investments is consistent with the continuing decline in available interest rates.
- For additional information concerning Premera's yields refer to the Investment Analysis page in this report.

Realized Gains and Losses

Realized Gains/(Losses)
(Excluding impairment losses):

(In Thousands)	Dec 31, 2002	Dec 31, 2001	Dec 31, 2000	Dec 31, 1999
<i>Fixed income securities</i>				
Realized gains	\$11,960	\$16,430	\$9,244	\$5,221
Realized losses	(9,926)	(4,492)	(7,498)	(6,454)
Net realized gains/losses	2,034	11,938	1,746	(1,233)
<i>Marketable equity securities</i>				
Realized gains	8,236	4,242	6,214	5,885
Realized losses	(21,694)	(8,665)	(1,856)	(4,971)
Net realized gains/(losses)	(13,458)	(4,423)	4,358	914
Net realized gain/(losses)	(\$11,424)	\$7,515	\$6,104	(\$319)

Impairment losses:

(In thousands)	Dec 31, 2002	Dec 31, 2001	Dec 31, 2000	Dec 31, 1999
Impairment losses recorded - Fixed income	(\$11,643)	-	-	-
Impairment losses recorded - Equities	(12,000)	-	-	-
	(23,643)	-	-	-
Total realized gain / (loss)	(\$35,067)	\$7,515	\$6,104	(\$319)

Source: Audited financial statements

Realized gains (losses)

Fixed income securities

- During 2002 Premera turned their fixed income portfolio 1.06 times (proceeds from sales, maturities, redemptions, calls & paydowns / average investment balance) as compared to 1.43 times during 2001. Since the decline in interest rates began during 2000 and continued through 2002, the company has been purchasing and selling fixed income securities with lower effective yields. As a result, the realized gain on fixed income securities has declined.

Marketable equity securities

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PROPRIETARY MATERIAL REDACTED

As a result, Premera turned their equity portfolio .88 times during 2002 as compared to .34 times the year before. This activity coupled with the significant declines in the equity markets are the most significant factors behind the December 31, 2002 realized loss of \$13.5 million increasing 200% over the prior year's loss of \$4.4 million.

Realized Gains and Losses, continued

PROPRIETARY MATERIAL REDACTED

Impairment consideration

- Although Premera is not currently under the jurisdiction of the SEC, they will become so if they complete an IPO. The SEC has recently challenged registrants for not impairing equity securities that have been "underwater" for 12 months or greater. If Premera were to adhere to this impairment criteria there would be a negative impact on net income in 2002. This impact has not been quantified. Since equity securities are carried at fair value, there would be no impact to surplus / equity.

Additional fixed income securities to be considered for impairment:
(In Thousands)

Security	Coupon	Carrying value	Fair value	Cost	Unreal Gain / loss	% Decline
Centerpoint Energy Co.	2	\$ 1,419	\$ 828	\$ 2,258	\$ (591)	-41.6%
General Motors Corp.	5.25	1,974	462	2,117	(1,512)	-76.6%
Liberty Media	3.5	2,010	1,796	2,005	(215)	-10.7%
U.S. Cellular Corp.	0	2,164	1,932	2,134	(232)	-10.7%
		<u>\$ 7,567</u>	<u>\$ 5,018</u>	<u>\$ 8,515</u>	<u>\$ (2,549)</u>	<u>-33.7%</u>

- Based on Schedule D, the securities presented above represent all securities in the fixed income portfolio which had an unrealized loss greater than \$150,000 and 10% of the carrying value and had not been impaired as of December 31, 2002. The \$2.5 million unrealized loss shown here comprises 90% of the overall unrealized loss in the fixed income portfolio.

Realized Gains and Losses, continued

PROPRIETARY MATERIAL REDACTED

- Liberty Media: This security experienced some recovery during the 4th quarter of 2002 and had not seen a sustained decline at December 31, 2002. As of June 20, 2003 this security had recovered considerably from its year-end price of \$64.13 to \$79.24 (recovery of approximately \$423,000 assuming the year end holding have remained unchanged).
- US Cellular: This security was purchased during October 2002 at a price of \$36.18 and had declined to \$32.75 by year end. As of June 20, 2003 this security had recovered considerably to \$46.12 (recovery of approximately \$800,000 assuming the year end holdings have remained unchanged).

Additional equity securities to be considered for impairment:
(In Thousands)

Security	Cost	Fair value	Unreal Gain / loss	% Decline
Bellsouth Corp.	\$ 675	\$ 440	\$ (236)	-34.9%
SBC Communications Inc.	883	643	(240)	-27.2%
Electronic Data Sys Corp.	248	92	(155)	-62.8%
Europacific Growth Fund	9,631	7,354	(2,277)	-23.6%
General Electric Co.	806	521	(285)	-35.4%
Honeywell Int'l Inc.	371	203	(168)	-45.2%
JP Morgan Chase & Co.	794	495	(299)	-37.7%
Verizon Comm. Inc.	1,112	881	(231)	-20.8%
	<u>\$14,520</u>	<u>\$ 10,629</u>	<u>\$ (3,891)</u>	<u>-26.8%</u>

Realized Gains and Losses, continued

The equity securities presented on the previous page represent the 8 largest unrealized losses in the equity portfolio and all equity securities where the fair value has declined below 90% of the cost and the security has not been impaired. These securities comprise 64% of the unrealized loss on equity securities as of December 31, 2002. While some market information was updated at June 30, 2003, we did not determine if the securities were still held by the Company.

- Bellsouth Corp. / Electronic Data Systems / Honeywell Int'l / Verizon: These securities had a 20% + sustained decline of greater than 6 months as of December 31, 2002. The price for each of these securities increased between year-end and June 20, 2003. Bellsouth increased from \$25.88 to \$26.69, EDS went from \$18.40 to \$22.97, Honeywell went from \$23.95 to \$28.05 and Verizon went from \$38.76 to \$40.40.
- SBC Communications: This security had a 20% sustained decline greater than 6 months as of December 31, 2002 and as of June 20, 2003 had seen additional deterioration. The year end price per share was \$27.13 and the June 20, 2003 price was \$25.61.
- Europacific: At December 31, 2002 this security had a 20% decline that had not been sustained for 6 months (although, the 2nd quarter decline was 18%). As of June 20, 2003 this security had recovered slightly from a year end price per share of \$22.97 to \$25.18.
- General Electric: As of June 20, 2003 this security had seen some recovery from its year-end price of \$24.35 to \$29.86, however, Premera's investment would still be down approximately 20%. In addition, there had been a greater than 20% sustained decline at year-end.
- JP Morgan: As of June 20, 2003 this security had seen significant recovery from its year-end price per share of \$24.02 to \$34.05. At year-end, there was not a sustained decline and the security had seen some recovery during the fourth quarter of 2002.

General & Administrative Expense

PROPRIETARY MATERIAL REDACTED

General and Administrative Expenses, continued

PROPRIETARY MATERIAL REDACTED

GAAP to STAT ADJUSTMENTS

GAAP to STAT Adjustments

Balance Sheet (Assets)

PROPRIETARY MATERIAL REDACTED

GAAP to STAT Adjustments

Balance Sheet (Assets), continued

PROPRIETARY MATERIAL REDACTED

GAAP to STAT Adjustments

Balance Sheet (Liabilities)

PROPRIETARY MATERIAL REDACTED

Income Statement

PROPRIETARY MATERIAL REDACTED

GAAP to STAT Adjustments

Income Statement, continued

PROPRIETARY MATERIAL REDACTED

TAXATION

Summary Assessment

Except for those items discussed below, there were no other significant tax matters that came to our attention with respect to the financial due diligence review. Further, it appears that the Company has reasonable basis in assessing its potential exposure to prior year federal and state income and premium tax contingencies and has provided for such taxes in its financial statements.

Given the uncertainty associated with certain tax contingencies, however, it is often difficult to fully assess the outcome of a potential assessment. The ultimate resolution of a particular tax matter depends on many factors including the extent to which a taxpayer is willing to defend itself against an assessment. It is possible that the Company could be assessed additional taxes in excess of the amounts currently provided for in the financial statements. If this were to occur, it is possible that such assessments could have a material adverse effect on the consolidated financial statements of the Company.

Please refer to PwC's Tax Report for information related to potential issues associated with the proposed conversion.

Status of Internal Revenue Service ("IRS") Examination Activity

PROPRIETARY MATERIAL REDACTED

PROPRIETARY MATERIAL REDACTED

PROPRIETARY MATERIAL REDACTED

Financial Statement Reporting for Income Taxes

Overview

- As of December 31, 2002, Premera has total net deferred tax assets of approximately \$102 million including a net operating loss carryover of \$26 million (after tax) and an AMT credit carryover of \$51.9 million.

Valuation Allowance

PROPRIETARY MATERIAL REDACTED

The valuation allowance was first established in 1993. The Company has also established a valuation allowance against all other temporary items to reflect the reversal of such amounts at a 20 percent tax rate (the alternative minimum tax rate). Premera believes that this treatment is proper as the Company expects to be an AMT taxpayer for the foreseeable future. As tax attributes are used, the valuation allowance associated with those items is adjusted accordingly.

Footnotes

PROPRIETARY MATERIAL REDACTED

- ² When insurance companies were first required to include S&S in taxable income in 1990, they were given a "fresh start" to mitigate the adverse tax impact. Insurance companies that included S&S in unpaid loss reserves could take a deduction equal to 83 percent of S&S included in IBNR (assuming such amounts had been properly disclosed in the NAIC annual statement) over a 3 year period. For those companies that did not include S&S in unpaid loss reserves, they were only required to include 13 percent in taxable income over a 3 year period.

- ³ When BCBS organizations became subject to tax in 1987, they were permitted to adjust the basis of assets held at that time to FMV for purposes of computing gain/loss on the ultimate disposition of such assets.

Premiums, Claims and Information Technology

Introduction

Our review of the premiums and claims cycles was primarily focused on the "BlueCHIP" mainframe processing system. This system supports the business operations and core processing requirements for approximately [REDACTED] % of Premera's insured membership base. Other systems support the Oregon and smaller lines of business (non-PPO). While not the focus of our procedures, we did consider and review the work of Premera's Quality Audit and Internal Audit Departments, and the work papers of the External Auditor as they related to these lines of business and their supporting premiums processing systems. Our examination did not encompass the new "Facets" system, which will eventually become the primary processing platform for Premera after a "sell over" process of members from the legacy systems to Facets. As of August 29, 2003, Facets supported approximately [REDACTED] % of Premera's members.

PROPRIETARY MATERIAL
REDACTED

PROPRIETARY MATERIAL
REDACTED

- Detailed process flowcharts have been created by the Internal Audit Department describing the underwriting and billing process for group and consumer premiums and for premium posting to the GL.
- The Group Underwriting Department maintains a formalized and documented peer review process for quality control.

PROPRIETARY MATERIAL REDACTED

Introduction, continued

PROPRIETARY MATERIAL REDACTED

- The Internal Audit Department regularly audits the operations of the Membership and Billing team for all systems.
- For premiums not processed on BlueCHIP (non-PPO), we reviewed the rotational testing performed by Premiera's External Auditor on these systems as documented in the annual audit work papers from 1999 – 2001.

Premiums, Claims and Information Technology

Introduction, continued

Observations

- We performed our review over BlueCHIP Membership and Billing functions onsite with Premera personnel during the week of December 16, 2002. We inquired with Premera personnel to the Membership and Billing functions as of August 29, 2003 and noted no significant changes. Our understanding of overall processes and procedures, as well as controls, was obtained from review of external audit workpapers and our interviews with the Director of Operations and the Manager of Membership and Billing. Our testing of controls included a walk-through of functions performed by billing representatives and observation of the processing of key transaction cycles on-line with M&B representatives. These transactions included:
 - Reconciliation process for a new enrollment
 - New member addition to a pre-existing group and billing reconciliation
 - Reconciliation of billing (Paid as billed)
 - Reconciliation of billing (Paid not as billed)
 - Cancellation of member from group and billing reconciliation
- Our limited onsite review did not expose any significant weaknesses in the internal control structure surrounding the operations of the BlueCHIP Membership and Billing team.

Premiums, Claims and Information Technology

Claims

PROPRIETARY MATERIAL REDACTED

Claims, continued

PROPRIETARY MATERIAL REDACTED

Observations

- We performed our review over BlueCHIP claims processing functions onsite with Premera personnel during the week of December 16, 2002. We inquired with Premera personnel to the Claims function as of August 29, 2003 and noted no significant changes. Our understanding of overall processes and procedures, as well as controls, was obtained from review of external audit workpapers and our interviews with a representative of the Operations Adjudication Analyst group, as well as with a Manager and Team Lead from Group Claims Operations. Our testing of controls included a walk-through of functions performed by claims examiners and observation of the adjudication of various suspense codes on-line as well as manual adjudication procedures with a level II claims examiner.

Claims, continued

- Our onsite review brought the following issues to our attention related to the overall control environment surrounding BlueCHIP Claims Processing:
 - Security profiles within BlueCHIP that determine the level of system access for claims examiners appears to inadequately limit access to sensitive privileges such as manual adjudication rights for personnel not requiring this level of authority. We noted that Internal Audit has documented numerous similar security limitations related to the BlueCHIP system in prior reports. Management has taken certain steps to mitigate these risks (such as increasing In-team audits and reviewing system access rights), but will not be dedicating the resources to fix these weaknesses of the mainframe application due to the roll out of the new Facets system.
- The BlueCHIP mainframe application is a batch update system, that requires a claims suspense process to be performed via a nightly batch process. As a result, generally only one suspense code can be worked on per claim / per day before it goes through the nightly batch update process to determine if there are any other issues associated with the claim that may cause it to suspend again. As a significant number of claims suspend more than once prior to full adjudication, this reiterative process increases the number of times a claim must be handled by an examiner. This increases the risk that turnaround deadlines for claims may not be met. However, this risk will be addressed by the implementation of the new Facets system. Facets is an on-line transaction processing system that will facilitate the complete processing of claims on a real-time basis, allowing suspense codes to be researched and cleared and the claims to be adjudicated all at one time.

Premiums, Claims and Information Technology

Information Technology

PROPRIETARY MATERIAL REDACTED

- The IT department is highly centralized, and therefore there does not appear to be significant IT activities outside of the IT function.
- In October 2002, the Information Systems Security Department was established in order to create security policies and test existing security measures. Responsibilities of the department include evaluating Premiera's Information Systems Security Guide, Regulatory Requirements, and Corporate Policies.
- Key on-going projects include:
 - HIPAA compliance
 - Implementation of an integrated health insurance system ("Facets") which will eventually replace the current numerous legacy systems in production.
 - Business Continuity Project
 - Secure Email

Hardware and Software Overview

- The main premium and claim processing system within the organization is BlueCHIP, a mainframe system which was originally purchased and customized. A number of other systems and platforms currently exist for both premium/commission processing and claim/cash disbursement processing.
- The General Ledger system (GEAC) also resides on a mainframe platform and is a purchased solution that has been customized.
- Summary level data from the core premium & claim processing system (BlueCHIP) is rolled up to GEAC via a monthly batch process that is reconciled via both automated and manual processes.
- The legacy BlueCHIP along with other legacy premiums/claims and provider systems are being replaced by a single integrated health insurance system ("Facets") on a client/server platform. The new system will help reduce the maintenance costs associated with the many legacy systems currently employed. In addition, it has been designed around HIPAA compliance requirements and will be enabled for e-commerce initiatives.

Premiums, Claims and Information Technology

Information Technology, continued

- The Facets system went live in mid 2002, and is being rolled out in phases for new and renewal business. The legacy systems will continue to run parallel to Facets as Premera migrates membership to the new system. A schedule is maintained to track key performance indicators and the projected vs. actual monthly membership migration onto Facets.

Change Management

- Change management policies and procedures are in place, however, a documented policy detailing the Change Management cycle is still in development.

PROPRIETARY MATERIAL REDACTED

Premiums, Claims and Information Technology

Information Technology, continued

PROPRIETARY MATERIAL REDACTED

Premiums, Claims and Information Technology

Information Technology, continued

PROPRIETARY MATERIAL REDACTED

Internal and External Audits

- The Internal Audit Department regularly audits the Information Technology Control environment.
- Premera's independent external auditors perform an annual review of controls surrounding Information Technology as part of the financial audit.

Observations

We performed our review over the Information Technology Department onsite with Premera personnel during the week of December 9, 2002. We inquired with Premera personnel to the Information Technology function as of August 29 and updated our understanding to the control environment in the Information Technology section above. Our understanding of overall processes and procedures, as well as controls, was obtained from our interviews with the following key personnel:

- Chief Information Officer
- Vice President of Application Services
- Vice President of Business Systems Projects and Security
- Vice President of Information Processing Services
- Senior Security Architect

Appendix 1 – Approach and Scope of Work

Approach to our work

- Through August 1, 2003 PwC has participated in several conference calls and group meetings with various members of Premera. However, substantive, interactive meetings with key client contacts have been limited.
- The following summarizes the significant interactions we have had with Premera:
 - participated in an initial meeting with executive management in Seattle, Washington between November 26, 2002 and November 27, 2002,
 - visited the Company's head office at Mountlake Terrace, Washington between December 2, 2002 and December 20, 2002,
 - visited the Company's membership and billing office at Spokane, Washington on December 19, 2002,
 - participated in conference calls with various members of management between December 2, 2002 and January 22, 2003
 - participated in onsite meeting with the Company's Controller and in-house counsel on July 31, 2003, and
 - submitted questions and document requests through formal channels established by Premera
- We also had discussions with the Premera's auditors, Ernst & Young LLP, and reviewed the working papers for their audits of the Premera's accounts for the three years ended December 31, 2002.
- Actuarial, economic impact, compensation issues and a tax analysis are not included herein, but are addressed in separate documents.
- We obtained information from officials of the Group, including the following:
 - Juli Bowen, Controller
 - Sharilyn Campbell, VP Finance
 - John Domeika, SVP, General Counsel
 - Michael Heuer, VP of Application Services
 - Allen B. Kerr, VP of Business Systems Projects –Irma Kirk, Manager of Membership and Billing
 - Donna McClure, VP of IT Infrastructure – Cathie Peloke, Director of System Procedures / Configuration
 - Alan Smit, SVP, Chief Information Officer
 - Larry Zommick, Tax Manager

Accounting - General

For earnings and capital consideration remain cognizant of the potential for misclassification of items between the States of Washington, Alaska, and Other Locations.

Quality of financial information

- Review and assess the quality of GAAP and statutory financial information of the Company.
 - Review audited GAAP and statutory financial statements for the three years ended December 31, 2002, and unaudited quarterly information for 2003 (to the extent available).
 - Review the 2001 and 2002 external auditor GAAP and statutory audit workpapers to include the following areas of focus:
 - Scope of testing in areas such as valuation of investments not independently assessed by the Securities Valuation Office of the NAIC and other significant balance sheet classifications.
 - Integrity of data and related systems supporting the financial and actuarial valuation systems.
 - Actuarial, including policy and claim liabilities, adjustments and loss recognition provisions.
 - Review of contingencies, such as outstanding litigation and unasserted claims.
 - Review testing performed on data underlying the actuarial analysis.
 - Review of controls documentation and testing performed on premiums and claims process cycles.
 - Scope of Information Systems audit work.
- Review Company's risk-based capital as compared to peer group and other reorganization transactions.
- Review recent risk-based capital calculations and pro-forma risk-based capital calculations taking into account the proposed restructure.
- Develop an understanding of statutory to GAAP adjustments.

- Based upon information analyzed consider the impact of non-recurring and one-time items on GAAP net income for the year ended December 31, 2001 and year ended December 31, 2002.
- Analyze available financial information to assess the quality of GAAP net assets as of December 31, 2002.
 - Bonds and Stocks
 - Search for large investments in junk bonds
 - Obtain analysis of bonds by NAIC rating category and credit agency rating for each of the last two years.
 - For each significant position in non-investment grade bonds, obtain NAIC ratings and credit agency ratings for each of the last two years.
 - Obtain information on bond defaults during the last two years.
 - Search for significant investments in affiliates
 - Obtain and review Schedule Y for each of the last two years to obtain an understanding of Premera's legal entity structure and recent changes thereto.
 - Obtain and review Schedule D for affiliated investments and recent changes in affiliated investments.
 - Analyze the sources of changes in the admitted value of significant affiliates.
 - Evaluate whether there are any valuation issues at affiliated companies that should result in an adjustment of Premera's book value.
 - Search for and evaluate substantial unrealized losses in bond portfolio.
 - Obtain and review statutory and GAAP disclosures of unrealized gains and losses on securities for each of the last two years.
 - Analyze the specific issues representing the most significant unrealized gains or losses for each of the last two years based on Schedule D information or from electronic information provided by the Premera.
 - Obtain and review Premera's most recent watch list and understand how the list is developed and monitored.
 - Understand Premera's policy for other-than-temporary impairments.

- Search for and evaluate realized gains and losses in the bond portfolio.
- Obtain and review listing of bonds sold for the past three years ending December 31, 2002.
 - Consider the impact of bonds sold at a gain on future investment earnings.
- Selectively test market value of common stock portfolio as of December 31, 2002.
- Accounts receivable
 - Understand the composition of the receivable balance and the factors driving changes in the balances.
 - Consider the collectability of outstanding balances.
 - Review aging of receivable balances
 - Review history of bad debt
 - Assess the adequacy of the reserve for doubtful accounts
- Other assets and liabilities
 - Obtain detail of statutory and GAAP other assets and liabilities (including statutory write-in balances).
 - Assess the recoverability/quality of other assets.
 - Consider the risk of material understated / unrecorded liabilities.
 - Deferred compensation plan
 - Understand the plan, the related asset and liability amounts and the effects on net income recorded in the GAAP financial statements
 - Contingent Liabilities
 - General
 - Inquire of the status of pending litigation and identification of any potential litigation with Premera and its subsidiaries
 - Review legal representation letter from inside and outside counsel for the last two years
 - Guarantees of obligations
 - Review disclosures about the guarantees of obligations of affiliates or debt from statutory and GAAP financial statements.
 - Review legal documents relating to guarantees of obligations of affiliates and coordinate with legal team

- Market Conduct litigation
 - o Review disclosures of market conduct, sales remediation or mis-selling from statutory and GAAP financial statements.
 - o Obtain and review analysis of movements in market conduct liabilities, if any, for each of the last two years.
 - o Coordinate with legal team on review of adequacy of liability.
- Funding Commitments
 - o Request listing of any unfunded financial/investment commitments.
 - o Review Investment Committee minutes for investment funding commitments (e.g., mortgage loans, real estate development, venture capital funds, limited partnerships, etc.)
- Other Audits and examinations
 - Review the 2001 and 2002 audit management recommendation letters.
 - Review the two most recent statutory financial and market conduct regulatory examination reports (1993).
 - Review management representation letters for each of the last two years.
 - Review internal audit reports and communications with audit committee of internal audit department for the last two years for major control issues and cost reduction opportunities.

Premiums and Claims

- Through review of the external auditor and internal audit work papers and discussion with management develop an understanding of the premium and claims process (i.e., the establishment and updating the reserves etc.) and the related internal controls.
- Perform interviews of Company premiums personnel and obtain the following items related to underwriting and conduct interviews to inquire about:
 - Underwriting guidelines (including procedures manual)
 - Sample underwriting file
 - Sample policy and forms
 - Underwriting, lapse, and renewal information
 - Underwriting audit results
 - Key reports used by management to monitor the business
- Perform interviews of Company claims personnel and read the following materials:

- Relevant financial and statistical documents and special claim reports
- Work flows, procedures, and program
- Sample of claim files to validate information obtained during interviews and document reviews
- Key reports used by management to monitor the business
- Understand management's tools and reports for monitoring the premiums and claims cycle.
- Understand the automated system control edits and validations within the BlueCHIP application that support the premiums and claims cycle.
- Understand Quality Assurance responsibilities for testing controls within the premiums and claims cycles.
- Test the effectiveness of controls within the premiums cycle (underwriting and enrollment/billing functions):
 - For a sample of new enrollments, perform a walk through of applications that are being underwritten to ensure adherence to underwriting guidelines and procedures.
 - Through inquiry and observation, obtain an understanding of the procedures performed by Membership & Billing to ensure that new groups are established within the appropriate state.
 - For a sample of new enrollments, observe controls ensuring that premium rates are approved and accurately input into the system.
 - For a sample of new enrollments, observe procedures performed by Membership & Billing personnel to ensure that benefits are appropriately recorded and other information is accurately input into the system.
 - Through inquiry and observation, obtain an understanding of the procedures performed by Membership & Billing to ensure that benefit payments are coded to the appropriate group, hence, to the appropriate state.
 - Through inquiry with Membership and Billing personnel, obtain an understanding of the controls that prevent duplication of membership applications.
 - Through inquiry and observation with Membership and Billing personnel, review and observe the effectiveness of controls over the accuracy of premium payments to the correct account/group and procedures that ensure the timely recognition and cancellation of delinquent accounts.
 - Obtain and review monitoring reports from Quality Assurance noting metrics audited and the current and historical trends in those metrics.
 - Obtain an understanding of personnel that have system access to underwrite new applications and process application of premium payments and test for appropriateness.

- Test the effectiveness of controls within the claims review and adjudication cycles:
 - With the assistance of a claims examiner, select a sample of claims and trace each claim through the adjudication process noting automated system based validation routines or edit checks that ensure the appropriate adjudication of each claim (i.e., claim payment in adherence with policy benefits and claims appropriately rejected for canceled members).
 - Through inquiry and observation, identify and observe the controls in place to ensure all claims are coded to the appropriate group, hence, the correct state.
 - Through inquiry and observation with claims personnel, identify and observe controls that ensure the appropriate processing of complex and high-dollar claims.
 - Through inquiry and observation with claims personnel, identify and observe controls that ensure the appropriate processing of claims submitted via EDI.
 - Obtain and review monitoring reports from Quality Assurance noting metrics audited and the current and historical trends in those metrics.
 - Obtain an understanding of personnel that have system access to establish a claim and the ability to process each claim and test for appropriateness.

Separation of Results by State

- Assess the ability of Premiera to specifically identify costs by region. Included within the economic impact report prepared by PwC.
- Understand the impact of allocated expenses (e.g., corporate overhead and general and administrative costs allocated to regions). Included within the economic impact report prepared by PwC.
- Understand the impact of allocated income (e.g., investment income). Included within the Actuarial report prepared by PwC.
- Analyze premium and expenses by state and assess the accuracy of the regional reporting. Included within the Actuarial report prepared by PwC.
- In conjunction with the system testing, understand and assess the systematic process for reporting and tracking premiums and claims by state.
- Perform Computer Automated Assistance Technique testing for select time period to validate state premium totals to detailed records.

Plan Conversion

PRICEWATERHOUSECOOPERS 

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- Understand and assess the proposed accounting treatment for the transaction.
- Review and assess Company assertions of improved utilization of capital resources as a result of restructure transaction.
- Review and assess Company's tax analysis of the restructure transaction.

Projected Financial Information

Included within a separate report prepared by PwC.

Accounting - Systems

Extent of the systems supporting the internal control environment

- Review the most recent external auditor GAAP and statutory audit work papers to include the following areas of focus:
 - Understand general computer controls testing and reliance placed upon those controls
 - Analyze system flow charts and diagrams
- Understand system feeds, interfaces and process reconciliation controls in place from legacy systems to the accounting system.
- Understand significant hardware / software supporting the business.
- Understand if there are any significant IT activities outside the IT function.
- Review and analyze control procedures for submitting, approving and authorizing changes to key applications.
- Review and analyze security control procedures for key applications, operating systems, and physical access to the data center.
- Review and analyze procedures for maintaining the IT operations. (i.e. backups, system utilization and monitoring, BCP / DRP, etc.)

Compensation

Included within a separate report prepared by PwC.

Taxation

Assess Current Tax Position and Historical Practices

- Review prior year federal income tax returns (1999, 2000, and 2001) and develop understanding of significant issues, accounting methods, and tax attributes. Review tax provision workpapers (1999 – 2002).
- Review and assess the statutory income tax provision and the related balance sheet accounts under SSAP #10.
- Review and assess the GAAP income tax provision under FAS 109 including the review of the effective tax rate reconciliations, adequacy of the current federal income tax payable/receivable accounts, and the computation and realization of deferred tax assets.
- Review the company's tax contingency accruals (GAAP/Statutory basis) and obtain an understanding of the significant tax contingency items as well as the status of tax examinations.
- A separate PwC report ("Tax Report") addresses various federal and state tax matters that arise in connection with the proposed plan of conversion. The Tax Report addresses, among other matters, (1) the tax-free treatment of the reorganization, (2) possible loss of Blue Cross and Blue Shield federal tax benefits, (3) possible restrictions on the utilization of tax attributes, (4) Foundation Shareholder and Charitable Organization tax matters, (5) various state tax matters, and (6) observations in connection with the proposed tax indemnification and other recommendations with respect to the reorganization documents.
- A separate PwC report ("Actuarial Report") addresses the coordination with the OIC' actuarial advisors in reviewing the historical actuarial contribution and tax assumptions and methodologies used in the prospective actuarial contribution.

Other

Other considerations

- Participation in "all hands" meetings, as well as any supplementary meetings with OIC, its advisors, the Company or its advisors as appropriate and necessary to ensure OIC is fully advised of the accounting and reporting implications of the matters to be discussed and that we are aware of issues being addressed and discussed by other members of the working group.
- Assist in preparation of questions for public hearing and presentation of testimony, including serving as an expert witness. [OPEN – Pending Completion]

Appendix 2 – Investment Price Testing

Investment Price Testing

- The securities presented below were selected from each of the company's respective December 31, 2002 Schedule Ds and subjected to price testing by PwC.
- As indicated, there were no significant exceptions noted in the company's price. Minor differences were noted due to rounding. Also, the interest rate and descriptions were agreed to an independent source.
- For price testwork done on equities refer to the Realized gains and losses pages of this report.

Fixed Income

(In thousands)

Company	Cusip	Description	Par value	Price	Mkt. Value	Bloomberg	
					Per Sched. D	Price	Mkt. Value
PBC	912827SS7	US Treas.	213,000	108.00	23,004,000	108.00	23,004,000
PBC	023551AH7	Amerada	11,100	109.23	1,212,431	109.27	1,212,897
PBC	55264TAZ4	MBNA	32,500	103.61	3,367,325	103.28	3,356,600
PBC	912810EL8	US Treas.	78,750	139.34	10,973,340	139.56	10,990,350
PBC	912810EO7	US Treas.	30,500	117.50	3,583,750	117.75	3,591,375
PBC	31293SD22	Fed. Home	49,270	104.22	5,134,923	104.22	5,134,923
PBC	31294KGF6	Fed. Nat	60,053	104.70	6,287,506	104.14	6,253,877
PBC	3133TSQU0	Freddie Mac	48,000	104.43	5,012,640	104.43	5,012,640
PBC	74955EAB5	RGS I&M	36,722	107.83	3,959,834	107.83	3,959,724
PBC	17305EAY1	Citibank	30,000	104.91	3,147,300	104.91	3,147,300
MSC	3134A35H5	Freddie Mac	6,000	119.28	715,686	119.16	714,960
MSC	912810EE4	US Treas.	8,300	144.16	1,196,495	144.12	1,196,196
MSC	36225A6X3	Govt Nat Mtg	5,800	105.79	613,632	104.31	605,047
SWL	912810DV7	US Treas.	46,250	148.41	6,863,778	148.17	6,852,863
LWW	36201JGQ6	Govt Nat Mtg	19,998	106.02	2,120,188	105.30	2,105,789

Appendix 3 – First Quarter 2003 Analysis

Appendix 3 – First Quarter 2003 Analysis

Income Statement

PROPRIETARY MATERIAL REDACTED

Appendix 3 – First Quarter 2003 Analysis

Income Statement, continued

PROPRIETARY MATERIAL REDACTED

Appendix 3 – First Quarter 2003 Analysis

Balance Sheet

PROPRIETARY MATERIAL REDACTED

Appendix 3 – First Quarter 2003 Analysis

Balance Sheet, continued

PROPRIETARY MATERIAL REDACTED

